VZCZCXRO3081
RR RUEHCN RUEHGH RUEHVC
DE RUEHGZ #0889/01 2190729
ZNR UUUUU ZZH
R 070729Z AUG 07
FM AMCONSUL GUANGZHOU
TO RUEHC/SECSTATE WASHDC 6353
INFO RUEHOO/CHINA POSTS COLLECTIVE
RUEAIIA/CIA WASHDC
RUEKJCS/DIA WASHDC

UNCLAS SECTION 01 OF 02 GUANGZHOU 000889

SIPDIS

SENSITIVE
SIPDIS

E.O. 12958: N/A
TAGS: ECON EFIN EINV PGOV CH
SUBJECT: Microfinance Poised to Fill Gaps Ignored By Banking Sector
-- Maybe

¶1. (U) SUMMARY: Extending financial services to China's rural poor continues to be an uphill battle with seemingly distant rewards. While foreign banks hope that WTO-driven reforms will allow greater access to China's "nouveau riche," there is no great clamor to extend services to the countryside where the returns are not as great and loans could charitably be described as problematic. This represents a gap that microfinance could fill, yet in practice microfinance in China has been lagging and the banking and credit needs of China's poor are largely unmet. Even so -- and despite the past use of inappropriate models, poor training, and cultural, demographic, and regulatory barriers -- the government and the microfinance community are optimistic about the future. END SUMMARY.

Why Can't The Poor Get Loans?

¶2. (SBU) China has made unprecedented strides to reduce national poverty in recent years, but barriers exist that still make it unattractive for banks -- both foreign and domestic -- to invest in the harder-to-reach rural provinces, according to Director of the China Foundation for Poverty Alleviation's (CFPA) Microfinance Department Liu Dongwen. It is still very expensive for banks to open branches in rural areas and there is little incentive to invest in technologies that have proved successful in other countries, such as cell-phone banking. The Postal Savings system is widely used by those who have enough to save, but it is difficult for the poor to receive loans there. Even the Rural Credit Cooperatives (RCC), set up to serve the financial needs of the rural poor with its network of 38,000 branches, are absent in 22 counties. Moreover, the RCC often requires collateral, excluding the poorest of the poor. A recent study by the People's Bank of China (PBC) found that fifty percent of farmers relied on informal money lending schemes to meet their credit needs.

¶3. (SBU) Liu cited low overall levels of available capital, better investment opportunities elsewhere, and high reserve requirements as the biggest disincentives for banks to loan to the poor. Many banks prefer to invest money in large projects in the country's developed eastern cities, where return on investment is particularly high. Additionally, he says that Chinese banking regulations prohibit loans from exceeding 75 percent of a bank's assets. (China recently raised its banking reserve requirement to 12 percent.) According to a paper by Liu's colleague, in 2006, China's banks took in about RMB 300 billion in rural savings but only distributed about ten percent of that amount back to rural areas in the form of loans and grants. Liu believes that the opening of a banking branch in a rural city could spur other banks to expand their presence, creating healthy competition and improving services for the poor there.

Turning a Blind Eye

¶4. (SBU) Institutional factors also contribute to the lack of

success of microfinance organizations in China. While the government is committed to encouraging the practice, China lacks a clear regulatory framework for microfinance institutions (MFIs). Chinese financial law prohibits non-financial institutions from providing financial services. Most microfinance institutions are registered as non-governmental organizations (NGOs) and must negotiate some temporary legal status in order to practice. PlaNet Finance China, an NGO operating in China, asserts that not only is the process less than transparent, but the lack of clear legal standing precludes them from some regulation and monitoring that could improve the industry. The government recently lowered requirements for rural financial institutions to gain village banking licenses, but prefers to grant them to new institutions.

¶5. (SBU) Another barrier which microfinance organizations face is that, without a banking license, they are legally prohibited from taking deposits in China. Many MFI models used in other countries incorporate the savings component as an integral part of the organization's business model; in the model, potential borrowers are educated through a savings program before ever receiving loan funds. Similarly, another model of self-help groups, where people contribute small sums to save together and take turns borrowing a larger sum, is forbidden in China due to government discouragement of citizen-formed groups. Many MFIs are, however, able to utilize group guarantees as part of their lending model.

Not India, nor Bangladesh

¶6. (SBU) The Grameen microfinance concept pioneered by Nobel Prize winner Muhammad Yunus found less-than-fertile soil when first introduced to China's agricultural population in the mid 1990s. The credit models that were adopted with little-to-no country specific modifications by organizations like the Women's Federation of Shanxi, the Rural Development Institute, and China's Ministry of

Finance, delivered less than dramatic results. A contributing factor that makes the Grameen model more difficult to apply here is that China's population density distribution is different from that of places like India and Bangladesh. In those places, even in rural areas, the populations are large and somewhat concentrated. In China, the rural populations are more spread out, with much smaller townships, making it difficult and costly to reach the sustainability required for efficient microfinance.

Collectively Individualistic

¶7. (SBU) MFI models have also had to adapt to traditional Chinese social factors. Chinese clients reportedly differ from their Bangladeshi neighbors, who have close ties and a sense of responsibility to the community. Ironically, according to Liu, Chinese prefer individual loans to group loans, and if they must engage in group lending they prefer to form groups with their own immediate relatives. Liu cited a lack of trust among neighbors, perhaps a legacy of corruption in both farming collectives and the village leadership system, as a defining quality of rural Chinese borrowers. Unfortunately, this mistrust erodes many of the advantages of the group-based lending that makes microfinance loan schemes so cost-efficient.

Creative Solutions Ease the Repayment Burden

¶8. (SBU) About 90 percent of China's rural population are farmers with cyclical income flow. Their cash needs are greatest during planting time, when they require money to buy seed and supplies. When they sell their crops after harvest, they are better able to repay their debts, but must budget in order to make ends meet all year round. This proves to be a difficult task for most and does not leave much room for unexpected expenses, a bad crop, or loss of livestock. As a result, the monthly repayment system used in many of China's early microfinance programs was unrealistic and met with failure. What works best? Flexibility and innovation, like the use of loans with a balloon payment -- where the farmer pays only

the interest on the loan monthly and repays the principal after the harvest.

Education and Financial Literacy Still a Problem
--- ----

¶9. (SBU) One of the greatest challenges for microfinance lenders is to educate rural borrowers about the concept of credit. In a country where previous poverty abatement projects amounted to little more that government handouts, basic financial literacy is still relatively undeveloped. One new concept for many rural borrowers is that they have to assume the risk of how the loan money is invested, even if the investment proves unsound. For example, farmers might not feel obligated to repay loan funds lost for reasons beyond their own control -- such as crop failures or livestock dying unexpectedly. Microfinance organizations must invest considerable time and energy to ensure that their loans are eventually repaid.

GOLDBERG